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AUDIT RISK ALERTS

Investment Companies Industry Developments — 2003/04

*Strengthening Audit Integrity
Safeguarding Financial Reporting*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

A U D I T R I S K A L E R T S

Investment Companies Industry Developments — 2003/04

*Strengthening Audit Integrity
Safeguarding Financial Reporting*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of investment companies with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an Other Auditing Publication as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Maryann Kasica, CPA
Technical Manager
Accounting and Auditing Publications

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Investment Companies Industry Developments—2003/04

How This Alert Helps You

This Audit Risk Alert helps you plan and perform your investment companies industry audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

If you understand what is happening in the investment companies industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk). You should refer to the full text of the accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this Alert.

Economic and Industry Developments

Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), among other matters, provides guidance for auditors regarding the specific procedures that should be considered in planning an audit in accordance with generally accepted auditing standards (GAAS). SAS No. 22 states that the auditor should obtain a knowledge of matters that relate to the nature of the entity's busi-

ness, its organization, and its operating characteristics, and consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit.

Also, paragraph 2.138 in the Audit and Accounting Guide *Audits of Investment Companies* states that economic conditions in the jurisdictions in which funds invest may affect the auditor's assessment of inherent risk for assertions in investment companies' financial statements. Factors that auditors should consider include local rates of inflation, government stability, and local tax rules. Auditors should consider whether such indicators create, intensify, or mitigate inherent risk.

For a thorough discussion of the economic and business environment, see the AICPA general *Audit Risk Alert—2003/04*.

Following declines in 2000, 2001, and 2002, the Dow Jones Industrial Average, NASDAQ Composite Index, and Standard and Poor's (S&P) 500 Index all were up as of the end of the third quarter of 2003. A wide range of stock funds posted gains through the first three quarters of 2003, welcome news for many investors following the reporting of negative returns by many stock funds in 2002.

The economic environment in the United States generally provided conditions that were favorable for many bond funds during the first half of 2003. Many bond funds performed well during the first half of 2003. During this time, prices on 10-year U.S. Treasury notes and 30-year U.S. Treasury bonds rose to levels that resulted in these securities at times trading at low yields not seen in decades. However, by the third quarter of 2003, yields on these securities had risen from these low levels. Also, the federal funds rate, at 1.25 percent since November 2002, was cut by the Federal Reserve Board in June 2003 to 1.00 percent. Low short-term interest rates in 2003, as in 2002, provided challenges for investment advisers or sponsors of money market funds seeking to maintain a positive yield to shareholders. (See the related discussion "Fee Waivers" in the "Audit Issues and Developments" section of this Alert.)

Recent investigations by state and federal regulators of late trading of fund shares, and trading in funds by market timers in a manner inconsistent with market timing policies described in fund prospectuses, have put these trading practices in the spotlight in 2003.

Securities and Exchange Commission (SEC) Chairman William H. Donaldson released a statement on October 9, 2003, noting that the SEC staff is considering new rules and rule amendments to prevent late trading abuses, and new rules and form amendments to curb market timing abuses. The new rules and form amendments under consideration to prevent market timing abuses include, among others, rule and form amendments that would require explicit disclosure in fund offering documents of market timing policies and procedures, and that would emphasize the obligation of funds to fair value their securities under certain circumstances to minimize market timing arbitrage opportunities. The statement is available on the SEC Web site at www.sec.gov. Readers can also refer to the SEC Web site to obtain additional updated information regarding SEC actions related to market timing and late trading, including recent testimony by members of the SEC and SEC enforcement actions. Readers should also be alert for enforcement actions and other developments initiated by state regulators.

The existence of enforcement actions alleging violations of laws and regulations raise numerous reporting and auditing implications. Investors in funds where late trading or improper trading by market timers were permitted may seek compensation for losses resulting from the dilution of fund gains. Investors may also respond to information about a fund's illegal or improper trading practices by redeeming shares in these funds, or opting for other investments. (See the related discussion "Redemptions" in the "Audit Issues and Developments" section of this Alert.) Also, as a result of these investigations, there may be greater scrutiny of trading policies and procedures by the fund board of directors. In response to increased scrutiny, mutual fund advisers or sponsors may be reexamining their market timing policies and procedures, or may charge redemption fees to discourage market

timers. Boards of directors may also be taking a look at procedures for valuation of investments and the use of fair value pricing by the fund. (See the related discussion “Auditing and Accounting for Investments” in the “Audit Issues and Developments” section of this Alert.)

Regulatory Developments¹

SAS No. 22, *Planning and Supervision*, states that in planning the audit, the auditor should consider matters affecting the industry in which the entity operates as they relate to the audit, including, among other matters, government regulations.

SEC Regulations

Since the writing of last year’s Alert, the SEC has issued a number of rules that may affect auditors of investment companies and their clients in the investment companies industry, including final rules to implement the requirements of the Sarbanes-Oxley Act of 2002. (See the AICPA general *Audit Risk Alert—2003/04* for a discussion of the Sarbanes-Oxley Act of 2002.) This section of this Alert provides brief summaries of some of these final rules.

- *Transactions of Investment Companies With Portfolio and Subadviser Affiliates* (Release No. IC-25888). In January 2003, the SEC adopted new Rule 17a-10 and amendments to Rules 10f-3, 12d3-1, 17a-6, 17d-1, and 17e-1 under the Investment Company Act of 1940 (1940 Act). The new rule and rule amendments permit investment companies and certain of their affiliated persons to enter into a variety of transactions and joint arrangements with-

1. Readers should be alert for updates, amendments, or other changes to the rules discussed in this section of the Alert and other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations and other documents that are discussed in this section of the Alert. The complete text of Securities and Exchange Commission (SEC) final rules discussed in this section of the Alert, rules adopted subsequent to the writing of this Alert, as well as proposed rules and other SEC information, can be obtained from the SEC Web site at www.sec.gov. See the “Information Sources” table at the end of this Alert for a list of some Web sites that can provide additional information on regulatory issues and developments.

out first obtaining an individual exemptive order from the SEC. Effective date: February 24, 2003. Compliance date: April 23, 2003.

- *Retention of Records Relevant to Audits and Reviews* (Releases No. IC-25911, No. 33-8180, and No. 34-47241). In January 2003, to implement Section 802 of the Sarbanes-Oxley Act of 2002, the SEC added Rule 2-06 to Regulation S-X, requiring accountants who audit or review the financial statements of a registered investment company to retain certain records relevant to that audit or review for seven years after the accountant concludes the audit or review. Effective date: March 3, 2003. Compliance date: Required on audits and reviews completed on or after October 31, 2003.
- *Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002* (Releases No. IC-25914 and No. 34-47262). In January 2003, the SEC adopted new rules, rule and form amendments, and new Form N-CSR under the Securities Exchange Act of 1934 (1934 Act) and the 1940 Act to better implement the certification requirement of Section 302 of the Sarbanes-Oxley Act of 2002 for registered management investment companies. Registered management investment companies are required to file semiannual certified shareholder reports on Form N-CSR (the certification requirements for Form N-SAR were removed). Reports on Form N-CSR are designated as periodic reports required under Section 13(a) or 15(d) of the 1934 Act. The registered management investment company's principal executive and financial officers are required to certify the information in these reports in the manner specified by Section 302 of the Sarbanes-Oxley Act of 2002. New Rule 30a-3 under the 1940 Act requires that registered management investment companies maintain, and regularly evaluate the effectiveness of, controls

and procedures designed to ensure that the information in filings on Form N-CSR is recorded, processed, summarized, and reported on a timely basis. Also, new disclosures are required on Form N-SAR and Form N-CSR to implement the “code of ethics” and “audit committee financial expert” disclosure requirements of Sections 406 and 407 of the Sarbanes-Oxley Act of 2002. Effective date: March 1, 2003, except that the effective date of the removal of the certification requirement from Form N-SAR for registered investment companies other than small business investment companies is May 1, 2003. See the release for compliance date information. (See the related discussion “Certification of Financial Statements Required by the Sarbanes-Oxley Act of 2002” in the “Audit Issues and Developments” section of this Alert.)

- *Strengthening the Commission’s Requirements Regarding Auditor Independence* (Releases No. IC-25915, No. IA-2103, No. 34-47265, and No. 33-8183). In January 2003, the SEC adopted amendments to the existing independence requirements for accountants that audit and review financial statements and prepare attestation reports filed with the SEC. The final rules add Rule 2-07 to Regulation S-X; add Rule 10A-2 under the 1934 Act; and amend Rule 2-01 of Regulation S-X, Item 9 of Regulation S-K, and Forms 10-K and N-CSR. Among other matters, the final rules:
 - 1) Revise the SEC’s regulations related to nonaudit services that, if provided to an audit client, would impair an accounting firm’s independence.
 - 2) Require that the registered investment company’s audit committee pre-approve all audit and nonaudit services provided by the independent accountant (a registered investment company’s audit committee also must pre-approve its accountant’s engagements for nonaudit services with the registered investment company’s investment adviser if the engagement relates directly to the operations and financial reporting of the registered investment company, with certain exceptions).

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- 3) Prohibit, with certain exceptions, certain partners on the audit engagement team from providing audit services for more than five or seven consecutive years, depending on the partner's involvement in the audit (the final rules do not allow audit partners to satisfy partner rotation requirements by rotating between investment companies in the same investment company complex, and define "consecutive years of service" for investment companies).
 - 4) Prohibit an accounting firm from auditing investment company financial statements if certain members of the investment company management were members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures (the one-year period extends to positions at any entity in the investment company complex that is directly responsible for the operations or financial reporting of the investment company).
 - 5) Require that the auditor report certain matters to the audit committee of the registered investment company, including all critical accounting policies and practices the issuer used; all alternative treatments within generally accepted accounting principles (GAAP) for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and the accountants' preferred treatment; and other material written communications with management.
 - 6) Require disclosures to investors of information related to audit and nonaudit services provided by, and fees paid by the investment company and other entities within the investment company complex to, the auditor of the financial statements.

Independence rules were also amended to address the scope of permissible and prohibited nonaudit services that may be provided to audit clients, and compensation of accountants by their firms for selling nonaudit products and services to audit clients. See the release for effective date

and transition information. Also, in March 2003, the SEC adopted technical corrections.

- *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies* (Releases No. IC-25922, No. 33-8188, and No. 34-47304). In January 2003, the SEC released a final rule adopting new Rule 30b1-4 and new Form N-PX under the 1940 Act, and amending Forms N-1, N-3, and N-CSR. The final rule requires a management investment company registered under the 1940 Act to:
 - 1) Disclose in its registration statement (and in the case of a closed-end fund, Form N-CSR) the policies and procedures that it uses to determine how to vote proxies relating to portfolio securities.
 - 2) File with the SEC and make available to its shareholders, either on its Web site or upon request, its record of how it voted proxies related to portfolio securities.
 - 3) Disclose in its annual and semiannual reports to shareholders and in its registration statement the methods by which shareholders may obtain information about proxy voting.

Registered management investment companies, other than small business investment companies registered on Form N-5, are required to file a Form N-PX each year containing the registrant's proxy voting record for the 12-month period ending June 30. Effective date: April 14, 2003. Form N-PX filings are first required for the 12-month period ending June 30, 2004. See the release for compliance date information.

- *Custody of Investment Company Assets with a Securities Depository* (Release No. IC-25934). In February 2003, the SEC adopted amendments to Rule 17f-4 under the 1940 Act. Rule 17f-4 governs registered investment companies' use of U.S. securities depositories. The amendments expand Rule 17f-4 to permit any registered investment company, including a unit investment trust or a face-amount

certificate company, to use a securities depository. The amendments also update the conditions that investment companies must follow to use a depository. Effective date: March 28, 2003.

- *Standards Relating to Listed Company Audit Committees* (Releases No. IC-26001, No. 33-8220, and No. 34-47654). In April 2003, the SEC adopted new Rule 10A-3 under the 1934 Act to implement the requirements of Section 10A(m)(1) of the 1934 Act, as added by Section 301 of the Sarbanes-Oxley Act of 2002. Under the new rule, national securities exchanges and national securities associations are prohibited from listing any security of an issuer that is not in compliance with the audit committee requirements mandated by the Sarbanes-Oxley Act of 2002. The requirements are:
 - 1) Each member of the audit committee of the issuer must be independent according to specified criteria.
 - 2) The audit committee of each issuer must be directly responsible for the appointment, compensation, retention, and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee.
 - 3) Each audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.
 - 4) Each audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.
 - 5) Each issuer must provide appropriate funding for the audit committee.

The SEC also adopted amendments to disclosure requirements regarding audit committees. Effective date: April 25, 2003. See the release for compliance date information.

- *Customer Identification Programs for Mutual Funds* (Release No. IC-26031). In April 2003, the U.S. Department of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), and the SEC jointly adopted a final rule applicable to investment companies that are mutual funds to implement Section 326 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001. A mutual fund must implement a written customer identification program (CIP) as part of the mutual fund's anti-money laundering program that includes risk-based procedures for verifying the identify of each customer to the extent reasonable and practicable. The procedures must enable the mutual fund to form a reasonable belief that it knows the true identity of each customer. The CIP must include procedures for determining whether the name of the customer appears on any list of known or suspected terrorists or terrorist organizations issued by any federal government agency and designated as such by the U.S. Department of the Treasury in consultation with the federal functional regulators. The final rule also includes recordkeeping and retention requirements. See the release for effective date and compliance date information. (See the related discussion "Anti-Money Laundering Programs" in this section of this Alert.)
- *Improper Influence on Conduct of Audits* (Releases No. IC-26050 and No. 34-47890). In May 2003, the SEC adopted a final rule to implement Section 303(a) of the Sarbanes-Oxley Act of 2002, prohibiting officers and directors of an investment company, an investment company's investment adviser, sponsor, depositor, trustee, and administrator, and any other person acting under the direction of these officers and directors, from taking any action to coerce, manipulate, mislead, or fraudulently influence the auditor of the fi-

nancial statements if that person knew or should have known that such action, if successful, could render the financial statements materially misleading. Effective date: June 27, 2003.

- *Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (Releases No. IC-26068, No. 33-8238, and No. 34-47986). In June 2003, the SEC adopted amendments to the rules and forms under the 1934 Act and the 1940 Act, revising the requirements implementing Section 302 of the Sarbanes-Oxley Act of 2002. The SEC also adopted amendments requiring issuers to provide the certifications required by Section 302 and Section 906 of the Sarbanes-Oxley Act of 2002 as exhibits to certain periodic reports. Effective date: August 14, 2003. See the release for compliance date information.
- *Certain Research and Development Companies* (Release No. IC-26077). In June 2003, the SEC adopted new Rule 3a-8 under the 1940 Act that provides a nonexclusive safe harbor from the definition of investment company for certain bona fide research and development companies. Effective date: August 19, 2003.
- *Amendments to Investment Company Advertising Rules* (Releases No. IC-26195, No. 33-8294, and No. 34-48558). In September 2003, the SEC issued a final rule adopting amendments to investment company advertising rules and technical amendments to registration forms used by investment companies. Effective date: November 15, 2003.

The following are summaries of some of the final rules that the SEC issued for investment advisers since the writing of last year's Alert.

- *Exemption of Certain Investment Advisers Operating Through the Internet* (Release No. IA-2091). In December 2002, the SEC adopted amendments to Rule 203A-2, Form ADV, and Schedule D to Form ADV under the Investment Advisers Act of 1940 (Advisers Act). The amendments exempt certain investment advisers that provide

advisory services through the Internet from the prohibition on SEC registration. Rule 203A of the Advisers Act generally prohibits an investment adviser from registering with the SEC unless that adviser has more than \$25 million of assets under management or is an adviser to a registered investment company. An adviser is eligible for registration under new Rule 203A-2(f) if the adviser provides investment advice to all of its clients exclusively through an interactive Web site, except that the adviser may advise fewer than 15 clients through other means during the preceding 12 months. Effective date: January 20, 2003.

- *Proxy Voting by Investment Advisers* (Release No. IA-2106). In January 2003, the SEC adopted new Rule 206(4)-6 under the Advisers Act. An investment adviser that exercises voting authority over client proxies is required to adopt policies and procedures reasonably designed to ensure that the adviser votes in the best interests of clients; discloses information to clients about those policies and procedures; and discloses to clients how they may obtain information about how the adviser voted. The policies and procedures must be in writing. Also, Rule 204-2 under the Advisers Act was amended to permit an adviser to rely on proxy statements filed on the Electronic Data Gathering, Analysis and Retrieval (EDGAR) system, and on proxy statements and records of proxy votes cast by the adviser that are maintained with a third party, such as a proxy voting service. Effective date: March 10, 2003. Compliance date: August 6, 2003.
- *Electronic Filing by Investment Advisers; Amendments to Form ADV; Technical Amendments* (Releases No. IA-2144 and No. 34-48167). In July 2003, the SEC adopted technical amendments to Forms ADV, ADV-W, and ADV-H, and related rules under the Advisers Act. Effective date: July 11, 2003.
- *Custody of Funds or Securities of Clients by Investment Advisers* (Release No. IA-2176). In September 2003, the SEC adopted amendments to Rule 206(4)-2 under the Advisers Act to reflect modern custodial practices and clarify circum-

stances under which an adviser has custody of client assets. Among the principal amendments were provisions that:

- 1) Relieve an adviser from sending account statements to clients and from the requirement for an annual surprise examination of securities by independent accountants if securities are placed with a qualified custodian and that custodian sends account statements directly to the clients at least quarterly.
- 2) Remove the requirement for advisers with custody of client assets to include an audited balance sheet as part of Form ADV.
- 3) Exempt pooled investment vehicles, such as limited partnerships or limited liability companies, from the reporting requirements of the rule if the pooled investment vehicle is audited at least annually and its audited financial statements are distributed to all beneficial owners within 120 days of the end of its fiscal year.

Effective date: November 5, 2003. Compliance date: April 4, 2004.

Self-Regulatory Organization Rules Approved by the SEC

Readers should refer to the SEC Web site at www.sec.gov to get information about self-regulatory organization (SRO) rules approved by the SEC. Among the SRO rules that the SEC approved in 2003 are:

- *Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc; Order Approving Proposed Rule Changes (SR-NYSE-2002-33 and SR-NASD-2002-141) and Amendments No. 1 thereto; Order Approving Proposed Rule Changes (SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138 and SR-NASD-2002-139) and Amendments No. 1 to SR-NASD-2002-80 and SR-NASD-2002-139; and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 to SR-NYSE-2002-33, Amendment Nos. 2, 3, 4 and 5 to SR-NASD-2002-141, Amendment Nos. 2 and 3 to SR-NASD-*

2002-80, Amendment Nos. 1, 2, and 3 to SR-NASD-2002-138, and Amendment No. 2 to SR-NASD-2002-139, Relating to Corporate Governance (Release No. 34-48745).

- *Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment Nos. 1 through 4 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 5 Thereto by the National Association of Securities Dealers, Inc. Relating to Restrictions on the Purchases and Sales of Initial Public Offerings of Equity Securities* (Release No. 34-48701). In October 2003, the SEC approved significant revisions to the regulations of the National Association of Securities Dealers (NASD) governing the manner in which NASD members may distribute new issues that would be codified as new NASD Rule 2790. The new rule is designed to protect the integrity of the public offering process by ensuring that, among other things, NASD members do not withhold securities in a public offering for their own benefit, or use them to reward persons who can direct future business to members. Among other things, the revision changes the definition of a “new issue,” revises the persons restricted from participating in new issue transactions, and modifies the preconditions that an NASD member must meet before selling a new issue to any account. While investment companies registered under the 1940 Act are not subject to this rule, the new rule may have significant effects on the operation of other types of collective investment vehicles, such as limited partnerships. Effective date: after a three-month transition period beginning upon issuance of NASD *Notice to Members* announcing SEC final action on proposed rule change.

Other SEC Developments

Special Study, Staff Report: Implications of the Growth of Hedge Funds

The staff of the SEC conducted a study of hedge funds, including their investment advisers and other service providers and their investors. The study focused on a number of key areas of staff concern, including recent increases in the number of hedge fund

enforcement cases, the role of hedge funds in the financial markets, and the implications of the SEC's limited ability to obtain basic information about hedge funds. The SEC staff also examined the emergence of registered funds of hedge funds and reviewed hedge fund disclosure and marketing practices, valuation practices, and conflicts of interest.

A report of the SEC staff's hedge fund study was issued in September 2003. *Implications of the Growth of Hedge Funds* outlines the staff's factual findings, identifies concerns, and recommends certain regulatory and other measures that the SEC should consider to improve the current system of hedge fund regulation and oversight. The report is available on the SEC Web site at www.sec.gov.

Special Study, Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds

In March 2003, the staff of the SEC Office of Compliance Inspections and Examinations, NASD, and the New York Stock Exchange (NYSE) conducted an examination sweep of 43 registered broker-dealers that sell mutual funds with a front-end sales load to determine whether investors are receiving the benefit of available discounts on front-end sales charges in mutual fund transactions, or breakpoint discounts. The results of this examination were summarized in the staff report released in March 2003, *Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds*, available on the SEC Web site at www.sec.gov.

A Joint NASD/Industry Task Force was convened to examine the issue of breakpoint discounts, and the Task Force Report, issued in July 2003, contains recommendations to address problems in delivering breakpoint discounts to investors. A copy of the report is available on the NASD Web site at www.nasd.com.

SEC Concept Release, Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws

In June 2003, the SEC published a concept release, *Rating Agencies and the Use of Credit Ratings under the Federal Securities*

Laws, seeking comment on various issues related to credit rating agencies, including the advisability and feasibility of eliminating the nationally recognized statistical rating organization (NRSRO) designation from SEC rules, and the advantages and disadvantages of possible alternatives identified in the concept release to the NRSRO designation. The possible alternatives identified in the concept release include the elimination of the objective test—ratings issued by NRSROs—from Rule 2a-7 under the 1940 Act, to rely solely on the subjective test—the credit analysis performed by the adviser to the money market fund—for purposes of determining asset quality. Comments were due July 28, 2003. See Releases No. 33-8326, No. 34-47972, and No. IC-26066.

Frequently Asked Questions on the Application of the January 2003 Rules on Auditor Independence

As noted earlier in the discussion “SEC Regulations” in this section of this Alert, in January 2003, the SEC adopted amendments to the existing independence requirements for accountants that audit and review financial statements and prepare attestation reports filed with the SEC. In August 2003, the SEC’s Office of the Chief Accountant released answers to 35 frequently asked questions about the application of the SEC’s rules on auditor independence. Question 35 provides a response to a question regarding the applicability of the independence rules to auditors of investment advisers that are nonissuers. These questions and answers are available on the SEC Web site at www.sec.gov.

Questions and Answers Regarding the Mutual Fund Customer Identification Program Rule

In August 2003, the staffs of the U.S. Department of the Treasury and the SEC released questions and answers regarding the mutual fund customer identification rule. (See the related discussion about the SEC’s final rule *Customer Identification Programs for Mutual Funds* in “SEC Regulations” in this section of this Alert.) The questions and answers are available on the SEC Web site at www.sec.gov.

SEC Division of Investment Management—October 2003 Letter Regarding Disclosure by Funds Investing in Government-Sponsored Enterprises

In October 2003, the staff of the SEC's Division of Investment Management issued a letter² stating the staff's belief that investment companies that invest in securities issued by U.S. government-sponsored entities should prominently disclose in their prospectuses that, although the issuer may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the U.S. Treasury. The prospectus should clearly disclose whether the securities of an agency, instrumentality, or corporation are (1) supported by the full faith and credit of the United States; (2) supported by the ability to borrow from the Treasury; (3) supported only by the credit of the issuing agency, instrumentality, or corporation; or (4) supported by the United States in some other way. The letter is available on the SEC Web site at www.sec.gov.

Anti-Money Laundering Programs

Since the writing of last year's Alert, the U.S. Department of the Treasury, through FinCEN, released a proposed rule amending Bank Secrecy Act (BSA) rules that would require certain investment advisers that manage client assets to establish anti-money laundering programs and minimum requirements for such programs. This proposed rule can be obtained on the FinCEN Web site at www.fincen.gov. Also, visit the FinCEN Web site for updated information about this proposed rule and for additional information about BSA regulations. Also, see the related discussion about the SEC's final rule *Customer Identification Programs for Mutual Funds* in "SEC Regulations" in this section of this Alert, and the discussion "Questions and Answers Regarding the Mutual Fund Customer Identification Program Rule" in this section of this Alert.

2. Letter from Paul F. Royce, director, SEC Division of Investment Management, to Craig Tyle, general counsel, Investment Company Institute, October 17, 2003.

Audit Issues and Developments³

Fraud

As a reminder, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), became effective for audits of financial statements for periods beginning on or after December 15, 2002. SAS No. 99 is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. SAS No. 99 supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A), and amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"). SAS No. 99 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, as stated in SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02, "Responsibilities and Functions of the Independent Auditor"). SAS No. 99 also amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended.

Auditors can also find helpful guidance in the section "Consideration of Fraud in a Financial Statement Audit" in Chapter 2 in the Audit and Accounting Guide *Audits of Investment Companies*. That section of the Guide discusses the guidance in SAS No. 99, tailored to provide examples of fraud risk factors for audits of investment companies. (See the related discussion "2003 Audit and Accounting Guide *Audits of Investment Companies*" in this section of this Alert.)

3. Readers should refer to the full text of the auditing standards and other pronouncements that are discussed in this section of the Alert. Readers should be alert for updates, amendments, or other changes to the rules discussed in this section of the Alert and for other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations and other documents that are discussed in this section of the Alert.

Practical Guidance

The AICPA Practice Aid *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (product no. 006613kk) provides a wealth of information and help on complying with the provisions of SAS No. 99. Moreover, this Practice Aid provides an understanding of the differences between the requirements of SAS No. 99 and SAS No. 82, which was superseded by SAS No. 99. This Practice Aid is an Other Auditing Publication as defined in SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

Help Desk—The AICPA's Antifraud Resource Center at www.aicpa.org/antifraud, on AICPA Online, is an online resource providing comprehensive tools, information, and resources devoted to the prevention, detection, and investigation of fraud.

Auditing and Accounting for Investments

Significance to the Overall Audit

An investment company's securities portfolio typically comprises substantially all its net assets. Accordingly, the audit of an investment company's investment accounts is a significant portion of the overall audit because of the relative significance of those accounts and of the related income accounts. In auditing the investment accounts, the auditor should consider various aspects of the investment company's transactions with brokers, custodians, and pricing services.

Although the overall direction of the investment activities of an investment company is the responsibility of its board of directors, the board typically delegates the routine operating and investment decisions to an investment committee, a portfolio manager, or in most situations, an investment adviser. For some funds, the adviser may be assisted by one or more subadvisers.

The composition of an investment company's portfolio is primarily a function of the company's investment objectives and strategy to achieve them. For example, for some funds, the composition

may reflect an investment objective that tracks the performance of a major index, such as the S&P 500 Index.

Guidance for Auditing Investments

Auditors should consider the guidance in the Audit and Accounting Guide *Audits of Investment Companies* when auditing investment accounts. (See the related discussion “2003 Audit and Accounting Guide *Audits of Investment Companies*” in this section of this Alert, which discusses the update of the Guide with conforming changes.) Paragraphs 2.137 through 2.179 provide guidance on auditing procedures for investment accounts. Among the matters discussed are the principal objectives in auditing the investment accounts, consideration of internal control, and examination of transactions and detail records, including portfolio transactions with affiliates and valuation of investments.

The auditing procedures in paragraph 2.140 in the Guide note that the auditor should review such relevant investment company documents as the latest prospectus, statement of additional information, certificate of incorporation, bylaws, and minutes of the board of directors’ and shareholders’ meetings to gain an understanding of the investment company’s investment objectives and restrictions, and consider whether management has a program to prevent, deter, or detect noncompliance with the investment company’s investment restrictions. The auditor should also consider whether the program has identified noncompliance with the stated investment restrictions and test the operation of the program to the extent considered necessary. An investment company’s failure to comply with its stated investment restrictions may be considered a possible illegal act that may have an indirect effect on the financial statements of the fund. Should an auditor become aware of the possibility of an illegal act, the procedures delineated in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), should be applied. Auditors may also be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in Section 10A(b)1 of the 1934 Act), to make a report to the SEC relating to an illegal act that has a material effect on the financial statements.

Additional audit guidance for auditing investments is available in SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and in the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. In January 2003, the Auditing Standards Board (ASB) issued SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328). SAS No. 101 contains expanded guidance on the audit procedures for fair value measurements and disclosures. Under SAS No. 101, the auditor's substantive tests of fair value measurements involve (1) testing management's significant assumptions, the valuation model, and the underlying data, (2) developing independent fair value estimates for corroborative purposes, or (3) reviewing subsequent events and transactions. SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted. The discussion of examination of transactions and detail records in Chapter 2 in the Audit and Accounting Guide *Audits of Investment Companies* was modified with the 2003 conforming changes to the Guide to incorporate guidance in SAS No. 101.

Auditors should also consider the need for using the work of a specialist for valuation of complex financial instruments or restricted securities. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), can be useful in providing guidance to auditors who use the work of a specialist in performing an audit in accordance with GAAS.

Accounting for Investments

Accounting guidance for investments, including methods of valuing investments, defaulted debt securities, and expenditures in support of defaulted debt securities, lending of portfolio securities, and accounting for foreign investments, is discussed in paragraphs 2.19 through 2.97 in the Audit and Accounting Guide *Audits of Investment Companies*.

Guidance on the valuation of investments is also provided in paragraph 1.32 in the Guide. Paragraph 1.32 states that values

and changes in values of investments held by investment companies are as important to investors as the investment income earned. Investment companies, therefore, report investments at fair value. The fair value of an investment is the amount at which the investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The best evidence of fair value is the quoted market price in an active market. In the absence of a quoted market price, amounts representing estimates of fair values using methods applied consistently and determined in good faith by the board of directors should be used.

As discussed in paragraph 2.34 in the Guide, the SEC's *Codification of Financial Reporting Policies* provides guidance on the factors to be considered in, and on the responsibilities for and methods used for, the valuation of securities for which market quotations are not readily available (Sections 404.3 and 404.4).

Auditors should also consider the guidance in the SEC Division of Investment Management staff interpretive letters.⁴ The interpretative letter issued by the staff of the SEC's Division of Investment Management in April 2001 (2001 Letter) states the staff's views on the obligations of funds and their directors under the 1940 Act to determine in good faith the fair value of the funds' portfolio securities when market quotations are not readily available, as well as other topics, such as the valuation of securities traded on foreign exchanges and the inappropriate use of fair value pricing for securities for which market quotations are readily available. The 2001 Letter states that funds should continuously monitor for events that might necessitate the use of fair value prices, and establish criteria for determining whether market quotations are readily available. Funds should assess the availability of market quotations for their portfolio securities each day by reviewing various factors.

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4. See Letter from Douglas Scheidt, associate director and chief counsel, SEC Division of Investment Management, to Craig S. Tyle, Investment Company Institute, December 8, 1999, and Letter from Douglas Scheidt, associate director and chief counsel, SEC Division of Investment Management, to Craig S. Tyle, Investment Company Institute, April 30, 2001. You can obtain these documents on the SEC Web site at www.sec.gov.

As discussed in paragraph 2.175 of the Guide, for items valued using a valuation model, the auditor should determine whether the investment company client has made appropriate disclosures about the method(s) and significant assumptions used to estimate the fair values of such investments. The auditor should become familiar with the SEC's Financial Reporting Releases on this subject, with an emphasis on Section 404.03 of the SEC's *Codification of Financial Reporting Policies*.

See the related discussion "Use of a Blockage Factor" in the "New Accounting Pronouncements and Other Guidance" section of this Alert.

Fee Waivers

Last year's Alert noted that the continuing declines in interest rates in 2002 resulted in the movement of money market fund yields, after expenses, near (and in a few cases below) zero. Short-term interest rates through the first three quarters in 2003 have remained low. A number of investment advisers or sponsors of money market funds in 2002 and again in 2003 have waived fees or assumed fund expenses to maintain a positive yield to shareholders. Auditors should consider the effect of these waiver and assumption agreements when conducting audits of their clients in the investment companies industry and determine whether they are properly accounted for and disclosed in fund financial statements. Auditors can find guidance in paragraph 7.38 in the Audit and Accounting Guide *Audits of Investment Companies* regarding voluntary and involuntary waivers, and in paragraphs 8.04 and 8.05 of the Guide regarding various types of expense limitation agreements.

Redemptions

Auditors can find useful guidance for auditing redemptions in Chapter 4 in the Audit and Accounting Guide *Audits of Investment Companies*. Some of the guidance presented in the Guide is discussed in this section of this Alert.

Funds have adopted a variety of ways for shareholders to redeem their shares, and the auditor should become acquainted with the par-

ticular redemption methods described in the fund prospectus. Investors redeem shares at net asset value although, in some instances, a fund may charge redemption fees, which to the extent received by the fund, are credited to capital. Some funds have added redemption fees to discourage “in and out” activity of market timers.

Certain kinds of funds (such as money market funds) may sell or redeem a large volume of shares in response to market volatility. The transfer agent’s controls over such activities as check writing, wire transfers, and telephone redemptions should be adequate to support periods of heavy volume.

Guidance about substantive procedures that an auditor may perform to test redemptions of fund shares can also be found in Chapter 4 of the Guide. As discussed in paragraphs 4.39 and 4.42 in the Guide, the auditor may wish to test whether details on the order form or other customer evidence used in processing a redemption agree with the copy of the form ultimately sent to the shareholder to confirm the redemption. Such tests should also determine whether the transactions conform with the fund’s prospectus and with the redemption options selected by the shareholder on his or her account application. The auditor should gain assurance that procedures are in place to determine that payables for shares redeemed are priced and settled promptly.

Paragraph 4.51 states that the auditor may wish to confirm balances payable for capital shares to be redeemed by the fund directly with the investor or the dealers who sell the fund shares. SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), provides guidance on the use of confirmations. Paragraph 4.51 also states that alternative auditing procedures may also be used to satisfy the auditor concerning payables for fund shares redeemed. As discussed in paragraph 4.52, management’s representation letter should state that fund shares were sold and redeemed in accordance with the fund’s prospectus and SEC and state securities regulations.

As discussed in paragraph 4.32, the auditor should understand the shareholder accounting and transfer function, whether performed by the fund or outside agents, and consider controls over

the processing of redemptions. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS. Also, weaknesses in internal control that the auditor concludes constitute significant deficiencies that are reportable conditions should be communicated to the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

If an investment company uses a service organization, transactions that affect the investment company's financial statements are subjected to controls that may be physically and operationally removed from the investment company. Consequently, the investment company's internal control may include controls that are not directly administered by the investment company. Planning the audit may require the auditor of the investment company to gain an understanding of controls at the service organization that may affect the investment company's financial statements. This understanding may be gained in several ways, including obtaining a service auditor's report. SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions.

Auditors engaged to issue a report on a service organization's controls may need to consider and address the risks of after-hours trading and improper market timing activity if the service organization is involved with securities transactions. Also, in the course of performing procedures at a service organization, a service auditor may become aware of fraud or illegal acts (such as late-trading activities) attributable to the service organization's systems, management, or employees. SAS No. 70, as amended (AU sec. 324.23), states that in such circumstances, unless clearly inconsequential, the service auditor should determine from the appropri-

ate level of the service organization's management whether this information has been communicated to the affected user organizations. If management of the service organization has not communicated this information and is unwilling to do so, the service auditor should inform the service organization's audit committee or others with equivalent authority. If the audit committee does not respond appropriately, the service auditor should consider whether to resign from the engagement.

For more information about SAS No. 70, see the Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772kk).

Some investment companies may have experienced increases in the volume of redemptions in response to changing market conditions. However, when performing analytical procedures in planning an audit with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting, the auditor may see unusually high levels of investment purchases and sales in relation to total fund net assets without apparent economic purpose. This is an example of an unusual or unexpected relationship that may indicate a material misstatement due to fraud. (See paragraph 2.104 in the Audit and Accounting Guide *Audits of Investment Companies*.)

Certification of Financial Statements Required by the Sarbanes-Oxley Act of 2002

As discussed in "SEC Regulations" in the "Regulatory Developments" section of this Alert, in January 2003, the SEC adopted new Form N-CSR. Registered management investment companies are required to file semiannual certified shareholder reports on Form N-CSR. The principal executive officer and principal financial officer of an investment company filing financial statements on Form N-CSR are required to disclose to the investment company's audit committee and independent auditors all significant deficiencies in the design or operation of internal controls that could adversely affect the investment company's

ability to record, process, summarize, and report financial data, and to identify to the auditors any material weaknesses in internal controls. Further, they are to disclose to the audit committee and the auditors any fraud, whether or not material, that involves management or other employees who have a significant role in the investment company's internal controls. For registered investment companies that include certifications of the principal executive officer and principal financial officer in filings on Form N-CSR, the individuals certifying in those capacities should also sign the representation letter in order to directly confirm and document the communications to auditors described in their certifications. Other officers who provide material representations during the audit should also be considered for inclusion as signers. (See paragraphs 2.141 and 11.24 in the Audit and Accounting Guide *Audits of Investment Companies*.)

2003 Audit and Accounting Guide *Audits of Investment Companies*

The Audit and Accounting Guide *Audits of Investment Companies* (product no. 012623kk) has been updated with conforming changes as of May 1, 2003, to reflect the issuance of authoritative pronouncements.

Among the conforming changes to the Guide are updates for accounting pronouncements Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and FASB Interpretation (FIN) No. 46, *Consolidation of Variable Interest Entities*. (See the related discussion "FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*" in the "New Accounting Pronouncements and Other Guidance" section of this Alert.)

Updates to the Guide for auditing pronouncements include conforming changes for SAS No. 99, SAS No. 100, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), SAS No. 101, and Audit Interpretation No. 16, "Effect on Auditor's Report of Omission of Schedule of Investments by Invest-

ment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940” of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.76-.84). The conforming changes prepared for the issuance of SAS No. 99 include the addition of a new section in Chapter 2 of the Guide providing an overview of the guidance in SAS No. 99.

Certain discussions in the Guide have been updated to reflect recent SEC developments, for example, to alert readers about the adoption of new Forms N-CSR and N-PX.

Recent Revision to AICPA Ethics Ruling

The Professional Ethics Executive Committee revised Ethics Ruling No. 41 under Rule 101: *Financial Services Company Client Has Custody of a Member's Assets*.

Help Desk—You can find the revision to the ethics ruling in the March 2003 issue of the *Journal of Accountancy*.

For a list of all recent revisions and other changes to AICPA ethics interpretations and rulings, including revisions to Interpretation 101-3, “Performance of Other Services,” of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), and for a discussion of professional ethics and independence developments, see the AICPA *Independence and Ethics Audit Risk Alert—2003/04* (product no. 022474kk).

New Auditing and Attestation Pronouncements and Other Guidance

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the writing of last year's Alert. The AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk) contains a summary explanation of all these issuances (the list includes guidance that is not applicable to the investment companies industry). The Public Company Accounting Oversight Board (PCAOB) sets standards for audits of

public companies. See the PCAOB Web site at www.pcaobus.org for information about PCAOB activities and any standards issued by the PCAOB. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to AICPA Online at www.aicpa.org/members/div/audit-std/technic.htm and to the PCAOB Web site. You may also look for announcements of newly issued standards in the *CPA Letter*, the *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards Team and available at www.aicpa.org.

SAS No. 101	<i>Auditing Fair Value Measurements and Disclosures</i> Issued in January 2003. This SAS is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted. (See “Auditing and Accounting for Investments” in the “Audit Issues and Developments” section of this Alert for additional discussion about SAS No. 101.)
Audit Interpretation of SAS No. 58, <i>Reports on Audited Financial Statements</i>	Interpretation No. 16, “Effect on Auditor’s Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940” Published in the June 2003 <i>Journal of Accountancy</i> .
Audit Interpretation of SAS No. 31, <i>Evidential Matter</i>	Amendment of Interpretation No. 2, “The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals” Published in the June 2003 <i>Journal of Accountancy</i> .
Audit Guide	<i>Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards</i> (with conforming changes as of May 1, 2003) This Audit Guide is the former Statement of Position (SOP) 98-3, <i>Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards</i> .
Attestation Interpretation of Statement on Standards for Attestation Engagements (SSAE) No. 10, <i>Attestation Standards: Revision and Recodification</i> (Not applicable to attest engagements on public companies)	Interpretation No. 5, “Attest Engagements on Financial Information Included in XBRL Instance Documents” Published in the November 2003 <i>Journal of Accountancy</i> .

(continued)

SOP No. 03-2 (Not applicable to attest engagements on public companies)	<i>Attest Engagements on Greenhouse Gas Emissions Information</i> Issued in September 2003. This SOP is effective for reports on attest engagements on greenhouse gas emissions information issued on or after December 15, 2003. Early implementation is permitted.
Practice Alert No. 2003-1 (Nonauthoritative)	<i>Audit Confirmations</i>
Practice Alert No. 2003-2 (Nonauthoritative)	<i>Journal Entries and Other Adjustments</i>
Toolkit (Nonauthoritative)	<i>Auditing Fair Value Measurements and Disclosures: Allocations of the Purchase Price Under FASB Statement of Financial Accounting Standards No. 141, Business Combinations, and Tests of Impairment Under FASB Statements No. 142, Goodwill and Other Intangible Assets, and No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets</i>
PCAOB Rule 3100T (Applicable to public company audits only)	All registered public accounting firms are required to adhere to the PCAOB's auditing and related professional practice standards in connection with the preparation or issuance of any audit report for an issuer and in their auditing and related attestation practices.
PCAOB Rule 3200T (Applicable to public company audits only)	In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with GAAS, as described in SAS No. 95, as in existence on April 16, 2003.
PCAOB Rule 3300T (Applicable to public company audits only)	In connection with an engagement (1) described in the AICPA ASB's SSAE No. 10 and (2) related to the preparation or issuance of audit reports for issuers, a registered public accounting firm, and its associated persons, shall comply with the SSAEs, and related interpretations and SOPs, as in existence on April 16, 2003.
PCAOB Rule 3400T (Applicable to public company audits only)	A registered public accounting firm, and its associated persons, shall comply with quality control standards, as described in (1) the AICPA ASB's Statements on Quality Control Standards, as in existence on April 16, 2003; and (2) the AICPA SEC Practice Section's Requirements of Membership (<i>d</i>), (<i>f</i>) (first sentence), (<i>l</i>), (<i>m</i>), (<i>n</i>)(1) and (<i>o</i>), as in existence on April 16, 2003.

Of the pronouncements, guides, and other guidance listed above, those having particular significance to the investment companies industry are briefly explained below. This summary is for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies

of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

Audit Interpretation No. 16 of SAS No. 58, *Reports on Audited Financial Statements*

Audit Interpretation No. 16 of SAS No. 58 discusses the application of the guidance in AU secs. 508.41 and .42 to an auditor's report on the financial statements of an investment partnership that is exempt from SEC registration and that does not include in the Schedule of Investments all of the investment information required by paragraph 7.12 of the Audit and Accounting Guide *Audits of Investment Companies*.

The Interpretation states that the example in AU sec. 508.42 does not change the requirement in AU sec. 508.41 for the auditor to issue a qualified or adverse opinion and provide the missing information if practicable. If the investment disclosures required by the Guide are not included in the financial statements, and it is practicable for the auditor to determine them or any portion thereof, the auditor should include the information in his or her report expressing the qualified or adverse opinion.

The Interpretation further states that footnote 15 of AU sec. 508 indicates that it is practicable to provide the missing information if "the information is reasonably obtainable from management's accounts and records and ... providing the information in the report does not require the auditor to assume the position of a preparer of financial information." It would ordinarily be practicable for the auditor to obtain and present the information required in paragraph 7.12(b) in the Guide about investments constituting more than 5 percent of net assets. However, due to the need to categorize the investments for the purpose of preparing the schedule called for in paragraph 7.12(a) of the Guide, the auditor might be in the position of preparer of financial information and, therefore, would not include the schedule in his or her report. In rare cases, the Schedule of Investments information may be so limited that the auditor may conclude that disclosure of the entire Schedule is practicable.

The Interpretation also includes the following illustrations:

- A report that expresses a qualified opinion because the Schedule of Investments fails to disclose investments constituting more than 5 percent of net assets, but in all other respects conforms to the requirements of the Guide
- An adverse opinion relating to failure to present the entire Schedule of Investments and all of the related required information

New Accounting Pronouncements and Other Guidance

AICPA and FASB Pronouncements

Presented below is a list of accounting pronouncements and other guidance issued since the writing of last year's Alert. The AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk) contains a summary explanation of all these issuances (the issuances include guidance that is not applicable to the investment companies industry). These summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to AICPA Online at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 148	<i>Accounting for Stock-Based Compensation— Transition and Disclosure</i> Issued in December 2002. See paragraphs 4 and 5 of the Statement for effective date information.
FASB Statement No. 149	<i>Amendment of Statement 133 on Derivative Instruments and Hedging Activities</i> Issued in April 2003. This Statement is effective for contracts entered into or modified after June 30, 2003. This Statement is effective for hedging relationships designated after June 30, 2003. See paragraphs 39 and 40 of the Statement for additional effective date and transition information.
FASB Statement No. 150	<i>Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity</i>

Issued in May 2003. Most of the guidance in this Statement is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. See paragraphs 29 through 31 of the Statement for additional effective date and transition information, including effective date information for mandatorily redeemable financial instruments of a nonpublic entity. The FASB deferred the effective date of certain provisions of this Statement. See FASB Staff Position (FSP)⁵ No. FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150*, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, issued November 7, 2003.

FASB Interpretation No. 46	<i>Consolidation of Variable Interest Entities</i> Issued in January 2003. See paragraphs 26 through 29 of the Interpretation for effective date and transition information. See the discussion “FASB Interpretation No. 46, <i>Consolidation of Variable Interest Entities</i> ” in this section of this Alert for additional effective date information.
SOP 02-2	<i>Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator</i> Issued in December 2002. The provisions of this SOP are effective for fiscal years beginning after June 15, 2003. See paragraphs 10 and 11 of the SOP for additional effective date and transition information.
SOP 03-1	<i>Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts</i> Issued in July 2003. The provisions of this SOP are effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged.
Technical Practice Aids (Nonauthoritative)	<i>Software Revenue Recognition</i> Released in February 2003.

5. Beginning in February 2003, the FASB staff introduced the FASB Staff Position (FSP) to issue application guidance (like that found in Staff Implementation Guides and Staff Announcements). A final FSP is announced in *Action Alert* and posted to the FASB Web site at www.fasb.org, where it remains until incorporated into printed FASB literature. The guidance contained in an FSP is effective for new transactions or arrangements entered into after the beginning of the first fiscal quarter following the date that the final, Board-cleared FSP is posted to the FASB Web site. If the effective date of a recently issued pronouncement that is the subject of an FSP has not yet passed, then the guidance in the FSP should be incorporated into the adoption of the new pronouncement.

Of the pronouncements and other guidance listed above, those having particular significance to the investment companies industry are briefly explained below. This summary is for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

FIN No. 46, *Consolidation of Variable Interest Entities*, an interpretation of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, addresses the consolidation by business enterprises of variable interest entities (VIEs). FIN No. 46 would change the model for determining when to consolidate a controlling financial interest by requiring a VIE to be consolidated when the investment company is subject to a majority of the risk of loss from the VIE's activities or entitled to receive a majority of the entity's residual returns or both. FIN No. 46 also requires certain disclosures. Auditors of clients in the investment companies industry should note the exceptions to the scope of FIN No. 46 that are discussed in paragraph 4 of the Interpretation. Paragraph 4(e) of FIN No. 46 states that an enterprise subject to SEC Regulation S-X, Rule 6-03(c)(1), shall not consolidate any entity that is not subject to the same rule. Registered investment companies are not required to consolidate a VIE unless the VIE is a registered investment company.

FSP No. FIN 46-6, *Effective Date of FASB Interpretation No. 46, Consolidation of Variable Interest Entities*, issued in October 2003, defers the effective date for applying the provisions of FIN No. 46 for investment companies that are not subject to SEC Regulation S-X, Rule 6-03(c)(1), but currently account for their investments in accordance with the specialized accounting guidance in the AICPA Audit and Accounting Guide *Audits of Investment Companies*. The effective date of FIN No. 46 is deferred for such investments while the Accounting Standards Executive Committee (AcSEC) finalizes a proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide Audits of Investment*

Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies. (See the related discussion “AcSEC Exposure Draft, *Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*” in the “On the Horizon” section of this Alert.) Following issuance of the SOP, the FASB will consider whether to modify paragraph 4(e) to provide an exception for companies that apply the Guide as revised by the SOP.

The deferral does not extend to investments made after March 27, 2002, that are held by an investment company that is not a separate legal entity, unless those investments were acquired pursuant to an irrevocable binding commitment that existed prior to March 28, 2002. See the FSP for effective date and transition information.

You can find additional accounting guidance about consolidation by investment companies in Chapter 7 in the Audit and Accounting Guide *Audits of Investment Companies*. Readers should note the conforming changes adding a new footnote to paragraph 7.04 in the May 2003 edition of the Guide. (See the related discussion “2003 Audit and Accounting Guide *Audits of Investment Companies*” in the “Audit Issues and Developments” section of this Alert.)

FSP No. FIN 46-6 also defers the effective date for applying the provisions of FIN No. 46 for interests held by public entities in VIEs or potential VIEs created before February 1, 2003.

In October 2003, the FASB released an exposure draft of a proposed Interpretation, *Consolidation of Variable Interest Entities*. Among other matters, the proposed Interpretation would modify FIN No. 46 to provide an exception to the application of FIN No. 46 to mutual funds in the form of trusts and trusts of a bank's trust department and similar arrangements, unless they are used by a business enterprise to circumvent the provisions of that Interpretation. Visit the FASB Web site at www.fasb.org for updated information about the status of this exposure draft and developments about implementation issues related to FIN No. 46.

Use of a Blockage Factor

Footnote 20 to Chapter 2 in the Audit and Accounting Guide *Audits of Investment Companies* notes that during the clearance procedures for that Guide, the FASB expressed concern that an entity's ability to use a blockage factor to estimate an unrestricted investment's fair value when that investment has a quoted market price in an active market is unclear based on the guidance in paragraphs 2.30 through 2.36, paragraph 2.38, and paragraph 2.71 of that Guide. The FASB observed that the definition of fair value as used in FASB Statements No. 107, *Disclosures about Fair Value of Financial Instruments*, No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 133, *Accounting for Derivative Instruments and Hedging Activities*, prohibits use of a blockage factor in estimating an investment's fair value if a quoted market price is available.

As a result of diversity in current practice among those entities subject to the Guide regarding whether and when a blockage factor is applied in estimating fair value of an unrestricted investment that has a quoted market price in an active market and how that factor is measured, AcSEC undertook a project to address those concerns.

The Blockage Factor Task Force had completed most of its research and deliberations and was close to drafting an exposure draft of a proposed SOP, *Use of a Blockage Factor to Value an Unrestricted Investment that has a Quoted Market Price*. In November 2002, AcSEC ceased its efforts on this proposed SOP. Instead the FASB is addressing this issue, initially as part of the FASB's project on disclosures about fair value (FASB Statement No. 107 replacement project). The FASB decided in July 2003 to remove from its technical agenda the project on disclosures about fair value and address those issues as part of a broader project on fair value measurement. At its November 19, 2003, Board meeting, the FASB discussed Phase 1 scope and codification issues for the project on fair value measurement, reconsidering certain of its tentative decisions in the former project to replace FASB Statement No. 107. Among the tentative decisions reached at the November 19, 2003, meeting, the FASB affirmed its March 2003

decision to retain, for financial instruments traded in active markets, the principle in FASB Statement No. 107 that establishes that the unit of account is the individual trading unit and prohibits a fair value measurement using a block discount. That tentative decision would require conforming changes to the Audit and Accounting Guide *Audits of Investment Companies* (see the FASB Action Alert No. 03-47, November 26, 2003). Additional information about FASB technical projects is available on the FASB Web site at www.fasb.org.

In December 2002, the Blockage Factor Task Force presented a memorandum to AcSEC, summarizing the task force's views on the use of blockage factors. AcSEC sent the memo to the FASB on January 24, 2003. The memo is available on AICPA Online at www.aicpa.org.

The Guide includes "standstill" provisions on current accounting practice. If it was an entity's accounting policy in investment company financial statements issued for fiscal years ending on or before May 31, 2000, to apply a blockage factor to estimate the fair value of certain unrestricted investments that have a quoted market price in an active market, the entity may continue to apply that policy to those and similar investments. However, disclosure of the existence of such a policy is required. Otherwise, an entity may not elect to adopt such a policy pending the completion of the FASB's project on measuring financial instruments at fair value.

In March 2003, AcSEC's Planning Subcommittee (PSC) decided that footnote 20 to Chapter 2 of the Guide should remain in effect until the FASB finalizes its fair value project.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Auditors of public companies should keep abreast of standards and rules issued by the PCAOB. The AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk) summarizes some of the more significant ongoing projects and exposure drafts outstanding. Presented below is brief information about

certain ongoing projects and exposure drafts that are especially relevant to the investment companies industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below and in the general *Audit Risk Alert—2003/04*. Readers should refer to information provided by the various standard-setting bodies for further information.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (Note that for audits of public companies, the PCAOB sets auditing standards)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board	www.fasb.org
Professional Ethics Executive Committee	www.aicpa.org/members/div/ethics/index.htm
Public Company Accounting Oversight Board	www.pcaobus.org

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site, AICPA Online. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process the submission more efficiently. Include your full name, mailing address, and, if available, your membership and subscriber number in the message.

Accounting Pipeline

AcSEC Exposure Draft, *Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

Chapter 1 in the Audit and Accounting Guide *Audits of Investment Companies* discusses the kinds of companies considered to be investment companies to which the provisions of the Guide apply. As noted in the Guide, the FASB expressed concerns regarding the clarity of the scope of the Guide. As a result, AcSEC has undertaken a project to address those concerns.

AcSEC released an exposure draft of a proposed SOP in December 2002, with a comment deadline of March 31, 2003, to address this issue. Among other matters, the proposed SOP provided specific conditions for determining whether an entity is within the scope of the Guide. Entities that met the required conditions would be required to apply the provisions of the Guide in presenting their financial statements. Entities that did not meet the conditions would be prohibited from applying the provisions of the Guide. At its July 2003 meeting, AcSEC discussed a revised draft of the proposed SOP, and at its September 2003 meeting, AcSEC approved a final SOP, *Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, subject to AcSEC's negative clearance of certain revisions and FASB clearance.

The Guide includes "standstill" provisions on current accounting practice. Until this project is finalized, an entity should consistently follow its current accounting policies for determining whether the provisions of the Guide apply to investees of the entity or to subsidiaries that are controlled by the entity. Further, the FASB has expressed its view that an investment company (other than a separate account of an insurance company as defined in the 1940 Act) must be a separate legal entity to be within the scope of the Guide (see the FASB Action Alert No. 02-14, April 3, 2002). Accordingly, the specialized accounting

principles in the Guide should be applied to an investment made after March 27, 2002, only if the investment is held by an investment company that is a separate legal entity. Investments acquired prior to March 28, 2002, or those acquired after March 27, 2002, pursuant to an irrevocable binding commitment that existed prior to March 28, 2002, should continue to be accounted for in accordance with the entity's existing policy for such investments. For further discussion of this matter, see the FASB Staff announcement in Emerging Issues Task Force (EITF) Topic D-74, *Issues Concerning the Scope of the AICPA Audit Guide on Investment Companies*.

Visit AICPA Online at www.aicpa.org to obtain updated information about this project and the status of the exposure draft.

AcSEC Exposure Draft, Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships

Historically, the guidance in the Audit and Accounting Guide *Audits of Investment Companies* has related principally to investment companies registered under the 1940 Act (and similar entities). Substantial changes were made with the most recent revision of the Guide, issued in December 2000, to clarify the differences in accounting and reporting by registered investment companies and nonregistered investment partnerships. However, despite those changes, questions continued to arise in the application of certain provisions of the Guide by nonregistered investment partnerships, principally because of the differences between the operating structures of nonregistered investment partnerships and registered investment companies. The questions relate in particular to paragraphs 7.65 and 7.68 of the Guide, which address presentation of financial highlights.

To assist practitioners, AcSEC formed a task force to prepare guidance in the form of questions and answers, commonly referred

to as Technical Practice Aids (TPAs).⁶ That task force's charge was limited to clarifying the application of the provisions of the Guide to nonregistered investment partnerships rather than modifying the Guide's requirements. The following TPAs were released by the AICPA in January 2002:

- *Clarification of Certain Terms When Reporting Financial Highlights by Non-Registered Investment Funds* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.04)
- *Disclosure of Per Share or Per Unit Data When Reporting Financial Highlights by Non-Registered Investment Funds* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.05)
- *Reporting of Classes of Shares When Reporting Financial Highlights by Non-Registered Investment Funds* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.06)
- *Computation of Financial Ratios When Reporting Financial Highlights by Non-Registered Investment Funds* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.07)
- *Computation of Expense Ratio When Reporting Financial Highlights by Private Equity and Venture Funds* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.08)
- *Computation of Financial Ratios When Reporting Financial Highlights by Partnership Funds-of-Funds and Master-Feeder Funds* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.09)
- *Computation of Total Return When Reporting Financial Highlights by Non-Registered Investment Funds* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.10)

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6. Section 6910 in the "Technical Questions and Answers" section of *Technical Practice Aids* includes questions and answers (Q&As) specifically pertaining to investment companies. The Q&As are nonauthoritative, and are based on selected practice matters identified by the staff of the AICPA Technical Hotline and various other bodies within the AICPA.

Continuing to address the application of the Guide to nonregistered investment partnerships, at its April 2003 meeting, AcSEC cleared for exposure, subject to AcSEC's negative clearance and FASB clearance, a proposed SOP, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships. The FASB did not object to the exposure of the proposed SOP, and it was released on July 15, 2003, with a 60-day comment period. The purpose of the SOP is to provide disclosure guidance to clarify the application of certain provisions of the Guide to nonregistered investment companies. The proposed SOP applies only to nonregistered investment partnerships that are within the scope of the Guide. The proposed SOP amends paragraphs 7.12, 7.65, 7.66, 7.67, and 7.68 of the Guide, and paragraph 11 of SOP 95-2. Illustrations would be added to Chapter 7 of the Guide, providing examples for calculating and disclosing certain financial highlights by nonregistered investment partnerships, and an example of the condensed schedule of investments. The proposed SOP also would incorporate and elevate in authority the guidance provided in TPAs No. 6910.04 through No. 6910.10, with certain revisions. The SOP would apply only to nonregistered investment partnerships that are within the scope of the Guide.

At its October 2003 meeting, AcSEC approved a final SOP, subject to Chair's clearance and FASB clearance. At its November 19, 2003, Board meeting, the FASB met with representatives of AcSEC and discussed clearance of this proposed SOP. The FASB did not object to issuance of this SOP subject to FASB staff review of any editorial changes being made by AcSEC. Visit AICPA Online at www.aicpa.org to obtain updated information about this project and the status of the exposure draft.

Proposed Statement of Position, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide Audits of Investment Companies*

The revised Audit and Accounting Guide *Audits of Investment Companies*, issued in December 2000, requires that financial

highlights be disclosed for separate accounts, including net assets, unit fair value, and expense ratio, investment income ratio, and total return ratio as a percentage of average net assets.

In response to implementation questions, the AICPA released the following TPAs in February 2002 to address whether the requirement for presentation of financial highlights as noted in the Guide applies to separate accounts, and if so, what information should be presented:

- *Reporting Financial Highlights by Separate Accounts* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.11)
- *Reporting of Per Share or Per Unit Data When Reporting Financial Highlights by Separate Accounts* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.12)
- *Computation of Per Share or Per Unit Data When Reporting Financial Highlights by Separate Accounts* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.13)
- *Reporting Units Issued and Redeemed During the Period* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.14)
- *Transition* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 6910.15)

Questions remained after the issuance of the TPAs about the application of the required financial highlight disclosures.

AcSEC's PSC added to AcSEC's agenda a project to address reporting financial highlights by separate accounts. At its April 2003 meeting, AcSEC cleared for exposure, subject to AcSEC's negative clearance and FASB clearance, a proposed SOP, *Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide Audits of Investment Companies*. The FASB did not object to the exposure of the proposed SOP, and it was released on July 15, 2003, with a 60-day comment period. The proposed SOP applies to all entities that are considered separate accounts of life insurance enterprises, as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended, and paragraph 10.01 of the Guide.

The proposed SOP provides guidance on reporting financial highlights by separate accounts of life insurance enterprises. The proposed SOP would amend paragraph 7.66, paragraph 10.54, and paragraph 10.58(6) of the Guide, and incorporate and elevate in authority the guidance provided in the previously issued TPAs No. 6910.11 through No. 6910.15.

At its October 2003 meeting, AcSEC approved a final SOP, subject to Chair's clearance and FASB clearance. At its November 19, 2003, Board meeting, the FASB met with representatives of AcSEC and discussed clearance of this proposed SOP. The FASB did not object to issuance of this SOP subject to FASB staff review of any editorial changes being made by AcSEC. Visit AICPA Online at www.aicpa.org to obtain updated information about this project and the status of the exposure draft.

Auditing Pipeline

Substantial Changes to Audit Process Proposed (Note: These changes do not apply to audits of public companies)

In December 2002, the AICPA's ASB issued an exposure draft proposing seven new SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit.

The proposed SASs would be effective for audits of financial statements for periods beginning on or after December 15, 2004, in order to allow time for auditors to revise their methodologies and train their personnel to plan the initial application of these standards to their audits. Readers can access the proposed standards at AICPA Online at www.aicpa.org.

SEC Proposed Rules

Readers should refer to the SEC Web site at www.sec.gov to get information about proposed SEC rules. Among the proposed SEC rules that were released and not final as of the writing of this Alert, and that may be particularly relevant to the investment companies industry, are:

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- *Exemption from Shareholder Approval for Certain Subadvisory Contracts* (Releases No. 33-8312, No. 34-48683, and No. IC-26230)
 - *Compliance Programs of Investment Companies and Investment Advisers* (Releases No. IC-25925 and No. IA-2107)
 - *Fund of Funds Investments* (Releases No. 33-8297 and No. IC-26198)

Resource Central

Education courses, Web sites, publications, and other resources available to CPAs

AICPA Products and Publications

In addition to the AICPA publications already discussed in this Alert, the following are some of the AICPA products and publications that may also be of interest to auditors of investment companies.

Checklist Supplement and Illustrative Financial Statements for Investment Companies

The *Checklist Supplement and Illustrative Financial Statements for Investment Companies* (product no. 008944kk) is a nonauthoritative financial accounting and reporting practice aid that is updated annually. This checklist should be used in conjunction with the *Checklists and Illustrative Financial Statements for Corporations* (product no. 008934kk).

Audit and Accounting Manual

The *Audit and Accounting Manual* (product no. 005133kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditors' reports; checklists; and engagement letters, management representation letters, and confirmation letters.

AICPA reSOURCE

AICPA reSOURCE Online offers two online research libraries. The AICPA reference library provides instant access to the AICPA's *Professional Standards*, *Technical Practice Aids*, current Audit and Accounting Guides, current Audit Risk Alerts, and *Accounting Trends and Techniques*. The AICPA+FASB reference library, in addition to these AICPA materials, includes FASB and AICPA original pronouncements, current text, EITF abstracts, implementation guides, and a comprehensive topical index. To subscribe, go online at www.cpa2biz.com.

The AICPA also has a CD-ROM product titled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM also enables subscription access to the AICPA Professional Literature products in a Windows format.

For more information about these AICPA publications and products, call the AICPA (Member Satisfaction) at (888) 777-7077.

Education Courses

The AICPA has developed a number of CPE courses that are valuable to CPAs working in the investment companies industry, many of them available for both group study and self-study. Some of the AICPA's CPE products are discussed in this section of this Alert. For more information about AICPA CPE products, call the AICPA (Member Satisfaction) at (888) 777-7077.

Online CPE

AICPA InfoBytes. AICPA InfoBytes, offered exclusively through CPA2Biz.com, is the AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay \$149 (\$369 nonmembers) for a new subscription and \$119 (\$319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more visit www.cpa2biz.com.

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Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

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Members of the AICPA Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online and CPA2Biz

AICPA Online, www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs.

In addition, CPA2Biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

Other Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

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This Audit Risk Alert replaces the *Investment Companies Industry Developments—2002/03* Audit Risk Alert. The *Investment Companies Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to mkasica@aicpa.org or write to:

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